



ACQUISITION AND
TECHNOLOGY

THE UNDER SECRETARY OF DEFENSE

3010 DEFENSE PENTAGON
WASHINGTON, DC 20301-3010

MAR 3 2000

Honorable Albert Gore, Jr.
President of the Senate
Washington, DC 20510

Dear Mr. President:

The enclosed Department of Defense (DoD) report on Restructuring Costs Associated With Business Combinations is provided pursuant to 10 U.S.C. 2325, as added by section 804 of the National Defense Authorization Act for Fiscal Year 1998 (Public Law 105-85). Section 2325 requires DoD to submit a report to Congress regarding the estimated amount of savings, supporting rationale for allowing restructuring costs, and other information associated with restructurings involving business combinations occurring on or after August 15, 1994. Section 2325 also requires an assessment of any potentially adverse effects of the business combinations among major defense contractors on competition for DoD contracts, the national technology and industrial base, or innovation in the defense industry. In addition, it requires an assessment of the actions taken to mitigate potentially adverse effects. The enclosed report covers calendar year 1999.

At the time of Under Secretary of Defense (Acquisition, Technology and Logistics) certification or determination, the DoD share of estimated restructuring costs and savings associated with eight business combinations that occurred on or after August 15, 1994, was \$831.3 million and \$4,784.0 million, respectively. The estimated costs and savings at the time of certification or determination are projected for a five year period only; however, savings are expected to continue beyond the five year period. The DoD estimates that as of December 31, 1999, it has paid \$349.4 million in restructuring costs and realized savings of \$3,498.7 million from restructuring activities associated with these eight business combinations.

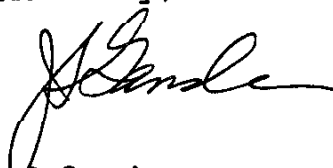
Of the forty-seven transactions that DoD reviewed during calendar year 1999, only three required action to protect DoD interests. The actions taken by the antitrust agencies and the Department to mitigate potentially adverse effects of these transactions are described in Part III of the report.



Portions of the enclosed report are marked *FOR OFFICIAL USE ONLY* because they contain confidential commercial or financial information provided by contractors to the Department. This information is exempt from release to the public pursuant to the Freedom of Information Act, 5 U.S.C. 552(b)(4) unless the submitter authorizes the release. Moreover, DoD would not release the information to the public in accordance with 18 U.S.C. 1905.

This report has been sent to the Speaker of the House and the Chairmen of the defense committees.

Sincerely,

A handwritten signature in black ink, appearing to read "J. S. Gansler", written in a cursive style.

J. S. Gansler

Enclosure:
As stated

**REPORT ON
RESTRUCTURING COSTS
ASSOCIATED WITH BUSINESS COMBINATIONS**



MARCH 1, 2000

**NOTE: COMPANY CONFIDENTIAL FINANCIAL DATA
HAS BEEN DELETED FROM THIS REPORT**

**Furnished in Compliance With
10 U.S.C. 2325, as Added by Section 804
National Defense Authorization Act
For Fiscal Year 1998
(Public Law 105-85)**

**REPORT ON
RESTRUCTURING COSTS
ASSOCIATED WITH BUSINESS COMBINATIONS**

PART I

10 USC 2325(b)(1), as added by PL 105-85, Section 804(a):

{W}ith respect to business combinations occurring on or after August 15, 1994, ...{f}or each defense contractor to which the Secretary has paid, under section 2324 of this title, restructuring costs associated with a business combination, provide a summary of the following:

(A) An estimate of the amount of savings for the Department of Defense associated with the restructuring that has been realized as of the end of the preceding calendar year.

(B) An estimate of the amount of savings for the Department of Defense associated with the restructuring that is expected to be achieved on defense contracts.

The summary on the following page provides the Department of Defense (DoD) share of estimated restructuring costs and savings that were expected to be achieved on defense contracts at the time of Under Secretary of Defense (Acquisition, Technology and Logistics) (USD(AT&L)) certification or determination, and the estimated DoD share of restructuring costs paid and savings that have been realized as of December 31, 1999, for each business combination occurring on or after August 15, 1994. At the time of USD(AT&L) certification or determination, the estimated DoD share of restructuring costs were \$831.3 million and savings were \$4,784.0 million. The estimated restructuring costs and savings at the time of certification or determination are projected for a five year period; however, savings are expected to continue beyond the five year period. The DoD estimates that as of December 31, 1999, it has paid \$349.4 million in restructuring costs and realized savings of \$3,498.7 million from restructuring activities associated with the eight business combinations, indicating that savings currently exceed costs by a factor of more than ten to one.

Business Combination	DoD Share of Estimated Restructuring Costs and Savings (Dollars in Millions)			
	At Time of Certification / Determination ¹		Actual Experience ²	
	Costs	Savings ³	Paid Costs	Realized Savings ³
Northrop / Grumman / Vought Aircraft ⁴				
GM Hughes Electronics / CAE-Link ⁵				
Lockheed / Martin Marietta ⁶ Electronics, Information, and Space Sectors Corporate Advanced Development Operations MMSI / LESC Home Offices Total				
Northrop Grumman / Westinghouse / Norden ⁷				
Lockheed Martin / Loral ⁸ Electronics Sector Corporate Information & Services Sector Electro-Optical Systems / Quintron Total				
Raytheon / Chrysler Technologies ⁹				
Boeing / Rockwell International Aerospace and Defense / McDonnell Douglas ¹⁰				
Raytheon / Texas Instruments Defense Systems and Electronics Group / Hughes Aircraft ¹¹ Phase I				
TOTAL	\$ 831.3	\$ 4,784.0	\$ 349.4	\$ 3,498.7

Footnotes:

1. The DoD share of estimated restructuring costs and savings at the time of certification are projected for a five-year period only; however, savings are expected to continue beyond the five-year period. Costs and savings amounts are shown on a discounted present value basis.
2. Actual experience is the DoD share of estimated restructuring costs paid and estimated savings realized as of December 31, 1999.
3. Savings are gross amounts.

4. Costs and savings data related to the Vought Aircraft Co. portion of the business combination cannot be segregated from the costs and savings related to the Northrop / Grumman business combination.
5. The Raytheon Company merged with Hughes Aircraft Company (part of GM Hughes Electronics) on December 17, 1997. Due to this merger and subsequent reorganization actions, realized savings cannot be determined beyond the \$[REDACTED] million reported as of December 31, 1998.
6. The Lockheed / Martin Marietta restructuring was accomplished in four phases: (1) Electronics, Information & Technology Services, and Space & Missile Sectors, (2) Corporate, (3) Advanced Development Operations, and (4) Martin Marietta Services, Inc. (MMSI), and Lockheed Engineering & Sciences Company (LESC) Home Offices.
7. Costs and savings related to Northrop Grumman Corporation's acquisition of Westinghouse Electric Corporation's Electronic Systems Group and its associated subsidiaries, including Norden Systems cannot be segregated from the costs and savings related to Westinghouse Electric Corporation's acquisition of Norden Systems, Inc.
8. Lockheed Martin / Loral restructuring was accomplished in 4 phases: (1) Electronics Sector, (2) Corporate, (3) Information & Services Sector, and (4) Electro-Optical Systems / Quintron. DoD paid no restructuring costs during calendar year 1999 for restructuring phases (2) through (4).
9. Costs and savings data related to Raytheon Company's acquisition of the Airborne Systems, Inc. and Electrospace Systems, Inc. business units of Chrysler Technologies, Inc.
10. Costs and savings data related to Boeing Company's acquisition of Rockwell International Corp.'s Aerospace & Defense Units cannot be segregated from costs and savings related to Boeing Company's merger with McDonnell Douglas Corp.
11. Costs and savings data related to Raytheon Company's acquisition of Texas Instruments Inc.'s Defense Systems and Electronics Group, cannot be segregated from the costs and savings related to Raytheon Company's merger with Hughes Aircraft Company. Restructuring is being accomplished in two phases: Phase I is complete; Phase II is in process.

REPORT ON RESTRUCTURING COSTS ASSOCIATED WITH BUSINESS COMBINATIONS

PART II

10 USC 2325(b)(2), as added by PL 105-85, Section 804(a):

[W]ith respect to business combinations occurring on or after August 15, 1994, ...[a]n identification of any business combination for which the Secretary has paid restructuring costs under section 2324 of this title during the preceding calendar year and, for each such business combination—

(A) the supporting rationale for allowing such costs;

(B) factual information associated with the determination made under subsection (a) with respect to such costs; and

(C) a discussion of whether the business combination would have proceeded without the payment of restructuring costs by the Secretary.

Identification. Business combinations that occurred on or after August 15, 1994, for which the Department of Defense (DoD) has paid restructuring costs during calendar year 1999 are identified below.

No.	Business Combination	Date of Business Combination	Date of USD(AT&L) Certification / Determination
1	Northrop / Grumman / Vought Aircraft	Apr 18, 1994 Aug 31, 1994	Feb 14, 1996
2	GM Hughes Electronics / CAE-Link	Feb 25, 1995	May 20, 1997
3	Lockheed / Martin Marietta Electronics, Information & Space Sectors Corporate Advanced Development Operations MMSI / LESC Home Offices	Mar 15, 1995	Nov 26, 1996 Jan 19, 1999 Jul 20, 1999 Jul 20, 1999
4	Northrop Grumman / Westinghouse / Norden Systems	Mar 1, 1996 May 31, 1994	Oct 14, 1998
5	Lockheed Martin / Loral Electronics Sector Corporate Information & Services Sector Electro-Optical Systems / Quintron	Apr 23, 1996	Oct 14, 1998 Dec 22, 1999 Dec 22, 1999 Dec 22, 1999
6	Raytheon / Chrysler Technologies	Jun 14, 1996	Nov 10, 1999
7	Boeing / Rockwell / McDonnell Douglas	Dec 6, 1996 Aug 4, 1997	Dec 17, 1999
8	Raytheon / Texas Instruments / Hughes Aircraft	Jul 11, 1997 Dec 17, 1997	Nov 9, 1999

Business Combination:

1. Northrop Corporation purchased Grumman Corporation on April 18, 1994, and purchased Vought Aircraft Company on August 31, 1994.
2. General Motors Hughes Electronics Corporation purchased CAE-Link Corporation on February 25, 1995.
3. Lockheed Corporation merged with the Martin Marietta Corporation on March 15, 1995.
4. Northrop Grumman Corporation purchased Westinghouse Electric Corporation's Electronics Systems Group and its associated subsidiaries, including Norden Systems, Inc. on March 1, 1996. Westinghouse Electric Corporation purchased Norden Systems, Inc. on May 31, 1994.
5. Lockheed Martin Corporation purchased most of the Loral Corporation on April 23, 1996. Lockheed Martin did not purchase Loral's Space divisions that were spun off into a new company, Loral Space & Communications, Ltd.
6. Raytheon Company purchased the Airborne Systems, Inc. and Electospace Systems, Inc. business units of Chrysler Technologies, Inc. on June 14, 1996.
7. The Boeing Company purchased the Aerospace and Defense business units of Rockwell International Corporation on December 6, 1996, and merged with McDonnell Douglas Corporation on August 4, 1997.
8. Raytheon Company purchased the Defense Systems and Electronics Group business unit of Texas Instruments, Inc. on July 11, 1997, and merged with the Hughes Aircraft Company business unit of General Motors Hughes Electronics Corporation on December 17, 1997.

Supporting Rationale. Contractor restructuring costs are allowable costs on defense contracts in accordance with the provisions of the Defense Federal Acquisition Regulation Supplement (DFARS) subsection 231.205-70, External Restructuring Costs, which prescribes policies and procedures for allowing contractor restructuring costs when net savings would result for the Department. During calendar year 1999, the subsection was amended by adding paragraph (f) to specify that contracting officers should consider using a repricing clause in noncompetitive fixed-price contracts that are negotiated during the period between the time a business combination is announced and the time the contractor's forward pricing rates are adjusted to reflect the impact of restructuring. The repricing clause must provide for a downward-only price adjustment to ensure that DoD receives its appropriate share of restructuring net savings.

DFARS 231.205-70 also implements Section 818 of the National Defense Authorization Act of Fiscal Year 1995 (PL 103-337), Section 8115 of the National Defense Appropriations Act for Fiscal Year 1997 (PL 104-208), Section 8092 of the National Defense Appropriations Act for Fiscal Year 1998 (PL 105-56), and Section 804 of the National Defense Authorization Act for Fiscal Year 1998 (PL 105-85).

Section 818 prohibits DoD from the payment of defense contractor restructuring costs associated with a business combination occurring prior to October 1, 1996, unless an official of the Department at the level of Assistant Secretary or above certifies that projections of future cost savings are based on audited cost data and should result in overall reduced costs for DoD. The review and certification requirements do not apply to any business combination for which restructuring costs were paid or otherwise approved before August 15, 1994. The audit review and certification provisions of Section 818(a) were repealed by Section 804(d) of the National Defense Authorization Act of Fiscal Year 1998 (PL 105-85).

Section 8115 prohibits DoD from using fiscal year 1997 funds to reimburse a defense contractor for restructuring costs associated with a business combination occurring on or after

October 1, 1996, unless the audited savings for DoD resulting from the restructuring will exceed the costs allowed by a factor of at least two to one, or the savings for DoD resulting from the restructuring will exceed the costs allowed and the Secretary of Defense determines that the business combination will result in the preservation of a critical capability that might otherwise be lost to DoD.

Section 8092 prohibits DoD from using fiscal year 1998 funds to reimburse a defense contractor for restructuring costs associated with a business combination occurring after November 18, 1997, unless the audited savings for DoD resulting from the restructuring will exceed the costs allowed by a factor of at least two to one, or the savings for DoD resulting from the restructuring will exceed the costs allowed and the Secretary of Defense determines that the business combination will result in the preservation of a critical capability that might otherwise be lost to DoD.

Section 804 specifies that similar conditions be met before DoD reimburses contractors for restructuring costs. For example, the section prohibits the reimbursement of restructuring costs unless the Secretary of Defense determines in writing that the amount of projected savings for DoD will be at least twice the amount of costs allowed. Section 804 also codifies the limitation and report on payment of restructuring costs under defense contracts provision at 10 USC 2325.

Factual Information. In order to be reimbursed for restructuring costs, a defense contractor must submit an overall plan of restructuring activities and an adequately supported proposal for planned restructuring projects. Upon receipt of the contractor's projected costs and savings, the cognizant administrative contracting officer (ACO) requests an audit of the proposal by the Defense Contract Audit Agency which performs an evaluation of the restructuring proposal. Findings and recommendations are issued to the ACO. Upon receipt of the audit report, the ACO makes a determination whether restructuring savings will exceed restructuring costs. For business combinations occurring on or after October 1, 1996, the audited projected savings for DoD must exceed the costs allowed by a factor of at least two to one, unless the preservation of a critical capability provision applies. An advance agreement is negotiated setting forth cost ceiling amounts on restructuring projects and a cost amortization schedule. The Defense Contract Management Command convenes a National Advisory Board of Review to review the restructuring advance agreement before submission to the USD(AT&L) for certification or determination, as required by Sections 818, 8115, 8092, or 804. Based on the Board's recommendation, the Under Secretary of Defense (Acquisition, Technology and Logistics) certifies that projections of future cost savings resulting for the Department are based on audited cost data and should result in overall reduced costs for the Department, or determines in writing that the amount of projected savings for the Department will be at least twice the amount of costs allowed.

At the time of USD(AT&L) certification or determination, each of the eight business combinations identified above met the audit, review, and limitation on payment of restructuring costs criteria of Section 818 or Section 8115.

Section 818 also requires that, before restructuring costs associated with a business combination can be paid, the USD(AT&L) must certify that the projections of future cost savings

resulting for the Department from the business combination are based on audited cost data and should result in overall reduced costs to the Department. Each restructuring associated with the six business combinations which occurred prior to October 1, 1996 (numbers 1 through 6, above), met the Section 818 criteria. Since these business combinations occurred before October 1, 1996, the restructurings were not required to meet the two to one savings-to-cost criterion of Section 8115; however, all did. USD(AT&L) certification was obtained for each restructuring.

Section 8115 also requires that, before restructuring costs associated with a business combination can be paid, the audited savings for DoD resulting from the restructuring must exceed the costs allowed by a factor of at least two to one. Each restructuring associated with the two business combinations which occurred on or after October 1, 1996 (numbers 7 and 8, above), met the two to one savings-to-cost criterion of Section 8115. USD(AT&L) determination was obtained for each restructuring.

Discussion. For each of the business combinations occurring on or after August 15, 1994, for which DoD has paid restructuring costs during calendar year 1999, the contractor was requested to provide a response to whether the business combination would have proceeded without the payment of restructuring costs by DoD. Contractor responses relating to business combination numbers 1 through 5 were provided in previous DoD Reports on Restructuring Costs Associated With Business Combination, dated March 1, 1998 (business combination numbers 1, 2, and 3) and report dated March 1, 1999 (numbers 4 and 5). The following responses relate to business combination numbers 6, 7, and 8:

Boeing / Rockwell / McDonnell Douglas. "At the time of the business combination(s), Boeing was aware of the ability to recover external restructuring costs. While that was certainly a positive element in the assessment of each of the business combinations, it could not be construed as the determining fact in either merger."

Raytheon / Chrysler Technologies.

Raytheon / Texas Instruments / Hughes Aircraft. "The proposed combination of Raytheon, Hughes Aircraft, and Texas Instruments were based upon various synergy studies of each business to determine the most efficient and cost effective way to operate. Raytheon, with the help of outside consultants, evaluated each program and business unit to combine these into the best use of facilities and manpower.

The projected cost and savings based on these combinations were projected to result in significant net savings in the cost of products and services acquired by the Department of Defense and government agencies.

The business combination of Raytheon, Hughes Aircraft, and Texas Instruments and the expected allocation of restructuring cost and generation of savings from these business combinations were part of the decision process. The recovery of cost was certainly a consideration in the combination of these companies; however, it was not the only element considered in determining this business combination."

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PART III

PL 105-85, Section 804, Paragraph (b)(3):

For business combinations of major defense contractors that took place during the year preceding the year of the report—

(A) an assessment of any potentially adverse effects that the business combinations could have on competition for Department of Defense contracts (including potential horizontal effects, vertical effects, and organizational conflicts of interest), the national technology and industrial base, or innovation in the defense industry; and

(B) the actions taken to mitigate the potentially adverse effects.

The Department of Defense (DoD) reviews the potential competitive effects of a merger or acquisition focusing on: horizontal consolidation, vertical integration, and organizational conflicts of interest. Horizontal consolidation occurs when, prior to the merger, the parties to the merger were direct competitors in procurements, either individually or as part of competing teams, and the merger would unduly limit competition in the defense market in question in the future. Vertical integration issues may occur if one party to a merger or acquisition is a key supplier to the other and to competitors of the other party, or if the combined entity could internally manufacture components rather than buy them from external suppliers. Organizational conflicts of interest may arise when one of the parties is providing a systems evaluation or technical assistance function and the other party may be supplying goods or services to the DoD for that program, or if the two parties are on competing teams for a DoD procurement.

DoD examines each of these possible effects and provides that information to the federal antitrust agency responsible for the transaction. In several cases, after consultation with the Department, these agencies required consent decrees with the acquiring party, or with both parties to a merger, to preserve competition. These consent decrees contained firewalls to protect proprietary information, agreements not to enforce exclusive teaming agreements, or divestiture of business units or specific programs. In other cases, the Department or the merging parties took action to remedy potential problems. These remedies included firewalls to protect proprietary information, ceiling prices for contracts not yet awarded, and acceleration of procurements so that all information required for a competitive procurement is obtained prior to merger consummation.

Of the forty-seven transactions that DoD reviewed during calendar year 1999, three required action to protect DoD interests: Exxon - Mobil, British Aerospace plc - Marconi

Electronic Systems, and Allied Signal - Honeywell. The merger of Exxon Corporation and Mobil Oil Corporation created the largest jet fuel refiner and marketer in the United States. DoD's review of this transaction disclosed no significant impact to DoD except in the bulk fuels market area for Navy jet aviation fuel (JP-5) on the West Coast. The merger reduced competitors for this product from three to two which was expected to result in an increase in the cost of JP-5 to DoD for that geographic region. We advised the Federal Trade Commission (FTC) that although DoD did not see any significant impact, we were concerned about future competition for JP-5 in the West Coast region. The FTC took DoD's concern into consideration in its review of the overall transaction. The parties entered into a consent decree that requires the divestiture of one of the West Coast refining plants. DoD continues to work with the FTC to ensure that the sale will not exacerbate the competitive concerns.

British Aerospace (BAE) plc acquired the Marconi Electronic Systems (MES) defense business of the General Electric Company plc on November 30, 1999. Before consummation of the merger, BAE and MES agreed to comply with certain interim undertakings, until the U.K. merger review process is completed, that address competitive concerns related to the Future Scout and Cavalry System (FSCS/TRACER) Program, a joint U.S./U.K. program, and the Joint Strike Fighter (JSF) Program. BAE and the former MES are competing prime contractors on the FSCS/TRACER Program and subcontractors on the two competing prime contractor teams on the JSF Program. Remedial measures required by the antitrust agencies include a series of information firewalls, investment commitments, financial incentives for key personnel and oversight mechanisms to ensure robust competition in the affected programs. These undertakings will not become final under the U.K. mergers process until the U.K. Secretary of State for Trade and Industry accepts and publishes them along with the other undertakings related to this merger. This is expected to occur in early 2000.

In the Allied Signal - Honeywell transaction, the consent decree required the divestiture of certain Allied Signal business units and technology. These divestitures included Allied Signal's Inertial Measurement Unit (IMU) technologies, an area of concern to DoD. We completed our review and subsequently cleared three of Allied Signal's divestitures required by the Department of Justice consent decree: 1) mechanical gyro/IMU business (Cheshire, CT) to Condor Pacific; 2) Space and Navigation (Teterboro, NJ) and MEMS IMU (Redmond, WA) businesses to L3 Communications Holdings; and 3) weather radar business unit to Telephonics, a subsidiary of the Griffon Corporation. A fourth required divestiture, Honeywell's Traffic Collision Avoidance System (TCAS) business will be reviewed in the beginning of 2000.